

TRUSTS FOR CHILDREN

A very common estate planning issue is how to provide for children. Many considerations go into this planning. The intent of this handout is to assist you in considering how you would like provisions for your children to read in your Living Trust or Will.

General Considerations: Under California law, a person becomes a competent adult at age eighteen. An inheritance cannot be received outright by a child until he/she reaches the age of eighteen. Conversely, if no provision is made to defer an inheritance, a child will receive all of his/her inheritance at age eighteen should you pass during the child's minority. This latter result is generally neither desirable nor wise. A person at age eighteen coming into a substantial amount of wealth could lose it or spend it imprudently. Most parents or grandparents would prefer that the money be directed toward the child's needs and to further his/her education. Distributing the money in installments as the child ages is the plan of choice by nearly all who approach this topic.

The law provides a commonly-used vehicle for passing wealth to a child in whatever manner fits your parental philosophy and choice. That legal vehicle is a trust. A trust for your children can be created either as part of the Living Trust which you prepare for purposes of avoiding probate proceedings or, alternatively, as a testamentary trust which is specified in your Will. The testamentary trust consists of a few paragraphs in your Will and only becomes effective when ordered into existence by a judge in the course of a probate proceeding. Similarly, the provisions in your Living Trust for your children would only become effective once you pass and the trust document directs the trust property to be applied for the use and benefit of your children.

Typical Provisions: You are at liberty to design your trust with whatever provisions you choose. The following is an illustration to assist you with that design process. Typically, a trust is established so that your children's needs such as support and health care are taken care of until age eighteen and thereafter while pursuing a college education and beyond. Usually, the trust also pays for the child's educational expenses, including tuition, room and board, books and supplies, and a reasonable amount of spending money and travel money (including a car). At some point, usually around age twenty-two when a child would be finishing college, distributions of the annual income of the trust are made to the child. Distributions of trust principal are typically made in increments; a common plan is 1/3rd at 25,

1/3rd at 30 and 1/3rd at 35. If a child should fail to live to age 35, his/her share would either continue to be held in trust for the benefit of his/her children or increase the shares of your other children or heirs.

Income Tax Considerations: Part of the logic behind the typical trust design is that income tax rates charged on trust income which accumulates are generally higher than individual rates. On the other hand, if income is distributed to a beneficiary, the income is taxed at the beneficiary's rate. By distributing for a child's needs and education, a fair proportion if not all of the income may be consumed; a child would pay taxes on that income at his/her marginal rates. Likewise, after college, starting generally at age 22, the income would pass directly to the beneficiary on a quarterly basis (monthly if desired) and the child would again pay the income tax on the income. Another approach to mitigating trust tax rates is to direct the trustee to place investments in tax free bonds so that there is no income tax issue to confront.

Size of Gift: Whether trust provisions make sense for your estate plan depends upon the amount of wealth which would be passed and the number of children among whom it would be divided. It is usually speculative as to what wealth might be passed and who will receive it, particularly if there were a common disaster. However, trying to project how much might be available for each beneficiary is useful as, should the amount be very large, the distribution scheme might be stretched out further. Alternatively, should the amount be small, the distribution plan might be compressed.

Character of Children: For some children, receiving a large inheritance at an early age might be a good thing. They might start a business, parlay it into greater wealth or perform wonderful acts. For others, the money might be wasted on substance abuse or fast living or lost in a bad marriage or to a fraudster. In devising your plan, it may be helpful to project how your child would handle receiving an inheritance. This is likely something that can be done as your child passes through the teen years. Obviously, for very young children, it is harder to project.

Special Needs Children: Should your child have a special need related to physical or mental disability, the trust can certainly have special provisions crafted to accommodate those needs. Similarly, some children have special problems, such as drug dependency, criminal proclivity, or chronic indebtedness. Provisions can be drafted to address all of these issues.

Distributions can be conditioned upon testing drug free or being out of jail. Housing can be maintained for a child without a creditor having the ability to attach the property. Such “black sheep” provisions may be appropriate for young adult children who have shown their ways.

Home Down-Payment Provision: In these days of costly housing, a common provision has become to allow trust monies to be used to provide a down-payment for the child to purchase a home. Generally, this provision would be useful if money is tied up until the child is into his/her mid-thirties or even forties and, as a young adult, has adequate income, either individually or with his/her significant other, to qualify for a loan. Typically, a “down-payment” provision would permit the trust monies to be used to provide part or all of the down-payment if the child could qualify for a loan equal to a certain percentage of the house’s purchase price, usually between 60% and 80%.

Incentivizing: Occasionally, trusts for children have certain incentives built into them. For example, graduate from college and you receive \$50,000. Or, there is a gift of \$25,000 to pay for a wedding ceremony or birth of a child. Many who consider such provisions ultimately reject them because they are either potentially not a good “fit” with the child or the provision may incentivize inappropriate conduct. For instance, to incentivize graduating from college or obtaining a post-graduate degree may be fair with a good student but demeaning to one who has trouble keeping up grades. Or, the wedding gift provision might motivate someone towards a marriage which is unwise to hurry. The same sort of problems can be conceived with respect to provisions that incentivize having children. Many reject this approach as they feel it is better for a child to learn to make decisions on his/her own rather than to try to rule from the grave.

Trustee and Guardian: Who you select as a Trustee is critical to how the Trust will be interpreted and administered. There is always an element of discretion, and judgment calls need to be made. The Trustee you choose should have character and values which are a good “fit” for your children’s needs. Likewise, the Guardian who would care for your children must be chosen with great sensitivity to your children’s well-being and future.

Generally, it is recommended that the Trustee and Guardian be different individuals as such an

arrangement creates important “checks and balances”. The Guardian will look to the Trustee to pay bills and tends to assure the trust funds are being handled properly. The Trustee will be interested in the proper application of funds distributed, thus overseeing the activities of the Guardian as to how money is spent on your children. Of course, you should have complete confidence in anyone chosen as Trustee or Guardian; the “check and balance” is, at best, insurance against human frailty in those you have trusted.

A Trustee should also be competent in financial matters. Investing generally should follow a prudent investor standard which preserves the principal while seeking a fair return of income. Diversification is normally required. Your choice of Trustee should include consideration of whether a candidate would have the skill and experience to make such investment calls. Geographical proximity to assets such as real property or a business or to the residence of the guardian and beneficiary may be helpful.

Alternative Vehicles: There are other means of passing property to children, but none which have the same degree of flexibility and certainty as a trust. Designating a child as an account beneficiary is one such approach frequently used via such devices as a pay-on-death account, an IRA beneficiary designation or a Uniform Transfers to Minors account (Probate Code §§ 3900 et seq), or a joint account. A financial institution manages the money and distribution occurs either at your death or when the child reaches a designated age (between 18 and 25 for the Uniform Transfers to Minor accounts). However, the ease of these arrangements is clouded by factors such as potential claims by the child’s creditors, the child’s accessing the funds, a lack of provision as to how the money would pass should the child die in a common disaster, irrevocability of a Uniform Gift to Minors transfer, etc. For these reasons, a trust is considered the Cadillac of vehicles for transferring wealth to a child.

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